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BETA-HEAVY MULTI-ASSET: WEIGHING YOU DOWN?

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BACKGROUND

Multi-asset investing, or allocating to one manager with the flexibility to invest across a range of asset classes, has evolved significantly over the past few decades. The universe of multi-asset strategies is a broad spectrum, ranging from traditional long-only funds to some that start to resemble hedge funds.

Mercer separates multi-asset strategies into four categories:

- Core multi-asset.
- Idiosyncratic multi-asset.
- Risk parity.[1]
- Diversified inflation.

We acknowledge that the distinction between the first two categories[2] isn't black and white. Some strategies can be very core, whereas others are very idiosyncratic, and many fall somewhere in between. Multi-asset strategies have rapidly grown in popularity, replacing the balanced fund of old as the most popular multi-asset investments for institutional investors.

The focus of this paper is on multi-asset strategies that rely heavily on market returns across the major equity and bond markets ("beta") as the key driver of return, with relatively little active management overlay, resulting in fairly static asset allocations. Such strategies will typically be found in the "core" multi-asset universe as well as at the simplistic end of the risk parity universe. These strategies are often anchored on a given split between equity and bond markets, classically around 60% equity/40% bonds (or equal risk weights in the case of risk parity), with investments largely constrained to positions that benefit if markets rise in value (that is, "long only" investments). To be clear, the "core" multi-asset strategies that are highly rated by Mercer are typically at the more dynamic end of the spectrum.

Strong returns across equity and bond markets over the period since the financial crisis have left few major equity or bond markets in "cheap" territory. This makes for a challenging environment for strategies that rely heavily on equity and bond beta as the key source of return. The sections that follow focus on the underlying building blocks of such strategies and consider the pros and cons of implementation via beta-heavy multi-asset funds.

> The environment has become challenging for strategies that rely heavily on equity and bond beta as the key source of return.

[1] Risk parity is a multi-asset approach to investing, which focuses on the equal allocation of risk, usually defined by volatility, to underlying market exposures. The risk-parity approach typically leverages the exposure to less volatile asset classes (such as bonds) so that the overall risk allocated to each asset class is broadly similar (the extent to which leverage is required depends on the return target).

[2] Core and idiosyncratic multi-asset strategies are often referred to as diversified growth funds (DGFs).

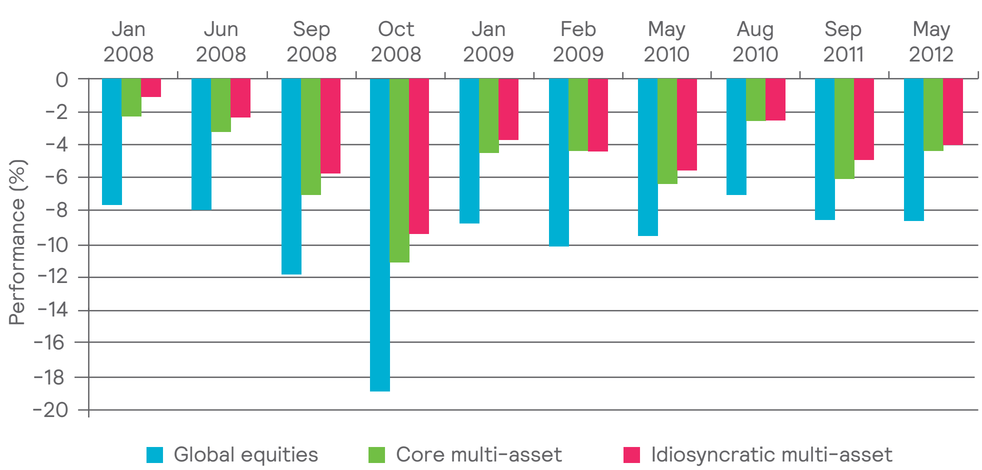
WHY MIGHT BETA-HEAVY MULTI-ASSET STRATEGIES STRUGGLE IN THE CURRENT ENVIRONMENT?

One of the themes we identified at the start of 2015 was our view that investors should consider tilting portfolios from market-return-oriented strategies (those designed to capture traditional beta) to those more dependent on manager skill (alpha). This was partly a reflection of the exceptionally strong returns achieved across major equity and bond markets since the financial crisis, which led us to conclude that the "easy beta" had been harvested from markets. Conversely, we believe opportunities for skilled and flexible active managers have improved as economic and policy divergence combine to create more volatility and dispersion in markets.

With elevated volatility and downside risk to major market exposures, the benefits of a more dynamic approach and a capital preservation mindset are much greater. The chart below shows the performance of global equities, compared to the average core and idiosyncratic multi-asset strategy during the ten worst months for equities over the last decade. The chart demonstrates that idiosyncratic multi-asset strategies, which tend to be less beta dependent and incorporate a greater focus on downside protection, have been better able to protect capital in falling markets than core multi-asset strategies.

Elevated volatility and downside risks call for dynamic approaches and capital preservation.

FIGURE 1: PERFORMANCE OF GLOBAL EQUITIES AND MULTI-ASSET STRATEGIES IN DOWN-MARKET



Source: MercerInsights

We also think strategies employing leverage — for example, risk parity — may find the current environment more challenging as reduced liquidity and heightened volatility increase the risks associated with leverage. Technically, the use of leverage makes an investor "path dependent," meaning the actions of such investors are, to some extent, determined by market movements (as opposed to "unlevered buy and hold" investors, who can simply choose to ride out market volatility). Specifically, levered investors may need to replenish collateral positions should markets move materially against them; this might require them to sell other asset exposures (which could also be falling in value). Prudent leverage management strategies will therefore be critically important in this environment.

Prudent leverage management strategies are critical in markets facing reduced liquidity and heightened volatility.

The key building blocks of beta-heavy multi-asset strategies are typically equities, fixed income (including both government and credit exposure), and, to varying degrees, commodities. In considering the appropriateness of these strategies, it's worth evaluating how a standalone allocation to each would be structured in the current environment.

Equities

Investment managers can structure the equity allocation within a multi-asset portfolio using a variety of approaches. Typically, these strategies will invest on a long-only basis, with a focus on capturing market returns rather than outperforming through stock selection.

Such approaches will often ignore sources of return such as style-factor biases (for example, value, momentum, low volatility, etc.) and idiosyncratic stock selection. We believe this leaves valuable sources of return on the table in an environment in which passive equity exposure might be expected to provide only moderate absolute returns.

Bonds

Beta-heavy multi-asset strategies will often include a material allocation to bond assets in order to diversify the total portfolio. In particular, simplistic risk parity strategies will often incorporate a meaningful exposure to government bonds in order to capture the "term premium." In the current low-yield environment, Mercer's Dynamic Asset Allocation Committee continues to view sovereign and corporate bonds as unattractive on a forward-looking basis. Therefore, the case for allocating a material portion of an investor's growth assets to these markets is relatively weak in the current environment.

Furthermore, we continue to favor building bond portfolios without reference to a market index, preferring either “buy and maintain” approaches to corporate bond investment or unconstrained active approaches. We also encourage investors to consider the broader credit universe, including assets such as high-yield bonds, bank loans, emerging market debt, and securitized credit, which can effectively be accessed via multi-asset credit strategies.

Finally, we think the interest rate exposure (or “duration”) provided by bond assets (especially long-dated government bonds) is more effectively managed within liability hedging portfolios for defined benefit pension schemes.

Commodities

Unlike equities or corporate bonds, where investors have historically been rewarded with a premium for sharing in a firm’s risk-taking, there is little theoretical basis for commodities offering a risk premium to investors. Without compelling evidence of mispricing, we don’t think investors should expect to be rewarded for passive exposure to commodities. As a result, we don’t recommend strategic allocations to commodities on a standalone basis and we therefore don’t support the passive commodity exposure often associated with risk-parity strategies.

That said, we believe commodity markets offer the potential for return generation by sophisticated macro investors with the ability to invest on both a “long” and “short” basis. Such strategies make sense as part of a diversified hedge fund portfolio.

WHAT DOES THIS MEAN FOR INVESTORS?

Although we don't think the current market environment lends itself to beta-heavy multi-asset approaches, we recognize that such strategies can make sense for some investors. In particular, heavily fee- and governance-constrained investors may have good reason to allocate to relatively straightforward multi-asset approaches as a low-cost means of achieving a diversified market exposure.

However, investors not facing significant fee and governance constraints should consider reviewing allocations to beta-heavy multi-asset strategies. As noted above, we believe the underlying components of these strategies could be designed to improve the risk-return profile by making use of additional return drivers (such as style-factor exposures), active management, and a broader opportunity set. In particular, we favor more dynamic mandates (for example, idiosyncratic multi-asset or multi-asset credit funds) or strategies driven more by manager alpha and non-traditional return drivers (for example, hedge funds) in the current environment.

Investors with no fee and governance constraints should consider reviewing allocations to beta-heavy multi-asset strategies.

For further information, please contact your local Mercer office or visit our website at www.mercer.com.

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